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In The

Supreme Court of the United States

October Term, 1990

NORWEST BANK DULUTH, N.A.,

Petitioner,

v.

MINNESOTA COMMISSIONER OF REVENUE AND THE STATE OF MINNESOTA,

Respondents.

CAMBRIDGE STATE BANK, ET AL.,

Petitioners,

v.

MINNESOTA COMMISSIONER OF REVENUE,

Respondent.

On Petition For Writ Of Certiorari To The Minnesota Supreme Court

BRIEF IN OPPOSITION

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QUESTIONS PRESENTED

1. Whether estopping petitioners who were beneficiaries of state bond exemptions from asserting that the bank tax is discriminatory violates due process.

2. Whether the Minnesota Supreme Court acted inconsistent with *McKesson* by not, as a matter of equity, actually imposing retroactive taxation of state bond interest where the petitioners themselves would have borne the brunt of it and where federal obligation immunity principles would not be furthered by retroactive taxation.

3. Whether the Minnesota Supreme Court's holding that *Memphis Bank* should be applied prospectively only is consistent with opinions of this Court.

TABLE OF CONTENTS

Page

QUESTIONS PRESENTED i

TABLE OF AUTHORITIES iv

STATEMENT OF THE CASE 2

REASONS FOR DENYING THE PETITION 6

I. DENYING REFUNDS TO THESE PETITIONERS DOES NOT UNDERMINE THE IMMUNITY OF U.S. OBLIGATIONS FROM STATE TAXATION ... 7

II. ESTOPPING PETITIONERS WHO WERE BENEFICIARIES OF STATE BOND EXEMPTIONS FROM ASSERTING THAT THE BANK TAX WAS DISCRIMINATORY DOES NOT VIOLATE DUE PROCESS 9

III. THE MINNESOTA SUPREME COURT DID NOT ACT INCONSISTENT WITH *MCKESSON* BY NOT, AS A MATTER OF EQUITY, ACTUALLY IMPOSING RETROACTIVE TAXATION WHERE THE PETITIONERS THEMSELVES WOULD HAVE BORNE THE BRUNT OF IT AND WHERE AN ACTUAL TAX WOULD NOT HAVE FURTHERED THE PRINCIPLE OF U.S. OBLIGATION TAX IMMUNITY 13

A. *McKesson* Is Not Applicable Because Minnesota Provided Predeprivation Relief 14

B. Even Were *McKesson* Applicable, *McKesson* Should Not Be Read to Prohibit A State From Declining, As A Matter Of Equity, To Impose A Retroactive Tax Where The Taxpayers Challenging The Tax Would Themselves Have Borne The Brunt Of It And Where An Actual Tax Would Not Have Furthered The Principle of U.S. Obligation Tax Immunity 16

TABLE OF CONTENTS – Continued

Page

IV. THE MINNESOTA SUPREME COURT'S HOLDING THAT *MEMPHIS BANK* SHOULD BE APPLIED PROSPECTIVELY ONLY IS CONSISTENT WITH OPINIONS OF THIS COURT AND IS CONSISTENT WITH THE OPINION OF THE ONLY OTHER STATE COURT TO RULE ON THE ISSUE 20

A. The *Memphis Bank* Opinion Decided An Issue Of First Impression Whose Resolution Was Not Clearly Foreshadowed 21

B. Retroactive Application Will Not Advance The Operation Of The Principle Of Federal Obligation Tax Immunity 27

C. Retroactive Application Of *Memphis Bank* Would Produce A Substantially Inequitable Result 28

D. The Dissenters In *ATA* Should Agree With The Decision Of The Minnesota Supreme Court 29

CONCLUSION 30

APPENDIX 1a

Phase I Stipulation of Facts ¶7 ..... 1a

Phase I Stipulation of Facts Ex. M-9 ..... 2a

Minn. Stat. § 290.531 (1982) 6a

TABLE OF AUTHORITIES

Page

FEDERAL STATUTES:

31 U.S.C. § 3124(a) 3, 12, 23

I.R.C. § 265 18

I.R.C. § 103 18

MINNESOTA STATUTES:

1933 Minn. Laws c. 405, § 12(g) 26

1983 Minn. Laws c. 213 28

1989 Minn. Laws c. 324 § 29 8

Minn. Stat. § 271.061 (1988) 3

Minn. Stat. § 290.531 (1982) 3, 15

FEDERAL DECISIONS:

American Trucking Ass'ns, Inc. v. Scheiner, 483 U.S. 266 (1987) 21

American Trucking Ass'ns, Inc. v. Smith, 110 S.Ct. 2323 (1990) 5, 19, 22, 29

Armco Inc. v. Hardesty, 467 U.S. 638 (1984) 22

Ashland Oil, Inc. v. Caryl, 110 S.Ct. 3202 (1990) 22

Bacchus Imports, Ltd. v. Dias, 468 U.S. 263 (1984) 22

Boston Stock Exch. v. State Tax Comm'n, 429 U.S. 318 (1977) 22

Bowmen v. City of New York, 476 U.S. 467 (1986) 18

Braun v. Sauerwein, 77 U.S. (10 Wall.) 218 (1869) 19

TABLE OF AUTHORITIES – Continued

Page

Burnett v. New York Cent. R.R., 380 U.S. 424 (1965) 18, 19

Canisius College v. United States, 799 F.2d 18 (2d Cir. 1986), *cert. denied*, 481 U.S. 1014 (1987) 17

Chevron Oil Co. v. Huson, 404 U.S. 97 (1971) . 6, 20, 27

Coldiron v. Commissioner, T.C.M. (P-H) ¶ 87,569 (1987) 11

Davis v. Michigan Dep't of Treasury, 489 U.S. 803 (1989) 7

Griffith v. Commissioner, T.C.M. (P-H) ¶ 89,070 (1989) 11

Kadrmas v. Dickinson Pub. Schools, 487 U.S. 450 (1988) 10

Magee v. United States, 282 U.S. 432 (1931) 10

Maryland v. Louisiana, 451 U.S. 725 (1981) 22

McKesson Corp. v. Division of Alcoholic Beverages and Tobacco, 110 S.Ct. 2238 (1990) ..... *passim*

Memphis Bank & Trust Co. v. Garner, 459 U.S. 392 (1983) ..... *passim*

Miller v. City of Milwaukee, 272 U.S. 713 (1927) 23

Schuylkill Trust Co. v. Pennsylvania, 296 U.S. 113 (1935) 24, 25

Strickland v. Flue-Cured Tobacco Coop. Stabilization Corp., 643 F. Supp. 310 (D.S.C. 1986) 10

United States v. New Mexico, 455 U.S. 720 (1982) 9

United States v. County of Fresno, 429 U.S. 452 (1977) 9

TABLE OF AUTHORITIES – Continued

Page

Unvert v. Commissioner, 72 T.C. 807 (1979) 11

Wilgard Realty Co. v. Commissioner, 127 F.2d 514 (2d Cir.), *cert. denied*, 317 U.S. 655 (1942)..... 18

Zipes v. Trans World Airlines, Inc., 455 U.S. 385 (1982) 18

MINNESOTA DECISIONS:

Bartlett v. Miller & Schroeder Muns., Inc., 355 N.W.2d 435 (Minn. Ct. App. 1984) 18

Gale v. Commissioner of Taxation, 228 Minn. 345, 37 N.W.2d 711 (1949)..... 10

State v. Duluth, M. & N. Ry., 207 Minn. 618, 292 N.W. 401 (1939), *reh'g denied*, 207 Minn. 637, 292 N.W. 411 (1940), *cert. denied*, 311 U.S. 719 (1941) 25

DECISIONS OF OTHER JURISDICTIONS:

Bass v. State of South Carolina, 395 S.E.2d 171 (S.C. 1990), *petition for cert. filed*, No. 90-673 (October 24, 1990) 7

First of McAlester Corp. v. Oklahoma Tax Comm'n, 709 P.2d 1026 (Okla. 1985) 6, 21

MISCELLANEOUS:

Black's Law Dictionary 1043 (5th ed. 1979)..... 10

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BRIEF IN OPPOSITION

The respondents Minnesota Commissioner of Revenue and State of Minnesota respectfully request that this Court deny the Petition for Writ of Certiorari (hereinafter "Pet.") seeking review of the decision of the Supreme

Court of Minnesota in this case. The opinion of the Minnesota Supreme Court is reported at 457 N.W.2d 716 (Minn. 1990) and is reproduced in the appendix to the Petition at page 1A (hereinafter "Pet. App.").

STATEMENT OF THE CASE

For nearly fifty years Minnesota has had a corporate franchise tax[1] which has included U.S. obligation interest in its net income measure. For a number of years Minnesota exempted from the tax two types[2] of Minnesota state/local bonds – the two whose statutory language appears in Petitioner's Appendix. Pet. App. 52A-53A. The

[1] Petitioners do not dispute the holding of the Minnesota Supreme Court, Pet. App. 4A-6A, that the bank tax is a franchise tax not an income tax.

[2] The retired district court judge who presided over the trial of this case and who signed without modification all proposed findings of fact and conclusions of law presented to him by the petitioner banks found several other types of bonds were exempt from the bank tax. *See* Pet. App. 6A n.4. The Minnesota Supreme Court did not reach the issue of whether these other bonds were exempt since respondents conceded that two types of bonds were exempt, which in itself was enough to present a discrimination issue for the court. *See* Pet. App. 3A n.2. Contrary to the trial court's finding, only two kinds of Minnesota bonds were exempt. Petitioners so concede as reflected by the fact that no other bonds are mentioned in their petition and only two exemptions are presented in their appendix. Pet. App. 52A-53A. The exemption language pertaining to bonds other than those two was in fact not sufficient to exempt them from a franchise tax as opposed to an income tax. Numerous bond counsel opinions to that effect were stipulated to in the case. *See, e.g.*, Resp. App. 5a, ¶6.

first was enacted in 1957 and provided an exemption for revenue bonds issued by the Minnesota State University System for construction of dormitories and other college buildings (SUB bonds). The second exemption was enacted in 1967 for industrial development bonds (IDB bonds).

During the years in which the exemptions were in effect prior to their repeal in 1983 neither petitioners nor any other taxpayer challenged the bank tax on the ground that it was discriminatory against U.S. obligations. Taxes were paid by the banks without objection for all of the 1979-1983 tax years for which they later claimed refunds. There was no requirement applicable to the 1979 and 1980 tax years that taxes be prepaid as a condition of challenging them.[3]

In early 1983 this Court issued its opinion in *Memphis Bank & Trust Co. v. Garner,* 459 U.S. 392 (1983). There the Court held that the Tennessee bank tax, which taxed U.S. obligation interest but exempted interest on *all* obligations of the state of Tennessee and *all* of its political subdivisions (over 70 types of bonds), was a discriminatory tax contrary to 31 U.S.C. § 3124(a).

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[3] A prepayment of taxes as a condition of an appeal to the Minnesota Tax Court was effective only for later tax years. *See* Minn. Stat. § 290.531 (1982). In 1989 the prepayment provision (which by then had been recodified as Minn. Stat. § 271.061 (1988)), was repealed. 1989 Minn. Laws c. 324 § 29. Consequently taxes may now be appealed in Minnesota without prepayment.

Even though it believed that Minnesota's bank tax, which exempted only two of the approximately 90 different types of Minnesota bonds,[4] was not unlawful under the rule of *Memphis Bank* the Minnesota Legislature immediately repealed the IDB and SUB exemptions in 1983, thus removing any conceivable discrimination.

Later in 1983 the petitioner banks and nearly all others in the state commenced filing refund claims for bank taxes back as far as 1979, citing the *Memphis Bank* opinion as grounds.

The Minnesota Supreme Court affirmed a trial court finding that the bank tax was discriminatory. The court denied refunds, however, on three separate grounds which, in view of the tortured and unfair description of them contained in the petition, respondents must restate.

The first was that any banks who were owners of exempt state bonds and beneficiaries of the state bond exemptions were estopped from asserting that the Minnesota tax system was discriminatory against U.S. obligations. It was stipulated that the four test banks[5] owned IDB's and benefited from the bank tax exemption. *See* Resp. App. 1a.

Second, the court ruled that any discrimination resulting from a difference in treatment between state and federal bonds should, consistent with this Court's opinion in *McKesson Corp. v. Division of Alcoholic Beverages*

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[4] Interest on all types of Minnesota state and local obligations (approximately 90 in number) other than SUB's and IDB's was not exempt.

[5] *See* Pet. 4 n.1.

and Tobacco, 110 S.Ct. 2238 (1990) (hereinafter "*McKesson*"), be remedied by declaring the state bond exemptions unconstitutional. The Minnesota court did not impose actual retroactive taxation, however, by ordering assessments on state bonds. It said that doing so in a Commerce Clause case like *McKesson* is appropriate because actual retroactive assessments could retroactively equalize the economic impact on competitors affected by the tax, *see* Pet. App. 11A, thereby advancing Commerce Clause objectives. In a federal obligation immunity case, however, the immunity principle is not furthered by actual retroactive assessment because actually undoing any damage done by the state policy is impossible. If the federal government was somehow damaged by Minnesota's tax policy that cannot be undone in this action.

The Minnesota court in the alternative found that it would, if compelled, actually impose a retroactive tax.[6] It did not impose an actual tax because it said actual collection would unfairly penalize the petitioners (who were owners of exempt bonds) for failing to foresee that Minnesota's tax exemptions would become unlawful under *Memphis Bank.*

As a third ground for denying refunds, the Minnesota court found that the *Memphis Bank* case should apply prospectively only. In reaching its conclusion, the Minnesota court, consistent with the recent opinion of this Court in *American Trucking Ass'ns, Inc. v. Smith,* 110 S.Ct.

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[6] Contrary to the statement of petitioners at p. 6 of their petition, respondents never asked the Minnesota court to impose an actual retroactive tax since that tax would have in large part fallen on the petitioners, banks being large holders of IDB's.

2323 (1990) (hereinafter "*ATA*"), applied the prospectivity analysis of *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971).

REASONS FOR DENYING THE PETITION

Petitioners never state the ground under Rule 10 on which their petition is premised. Presumably it is under the catch-all provision of Rule 10.1(c) that the decision of the Minnesota Supreme Court conflicts with applicable decisions of this Court.

The petition should be denied because the state court ruling is consistent with decisions of this Court issued in June, 1990 which have defined the law as to remedy issues in cases where state taxes are found to be unconstitutional. These issues have only recently been considered by the Court and the opinions in those cases provide sufficient guidance for the State courts.

The opinion of the Minnesota court is also consistent with the analysis of the Oklahoma Supreme Court in *First of McAlester Corp. v. Oklahoma Tax Comm'n*, 709 P.2d 1026 (Okla. 1985). *First of McAlester* is the only case other than the instant case to consider the *Memphis Bank* prospectivity issue. Since respondents believe there are no other cases pending on the issue in the State courts, they observe that no opinion inconsistent with the instant case and *First of McAlester* is likely.

Petitioners identify no pending *Memphis Bank* cases in which the Court's guidance is needed. They assert instead that the Court should review this case in order to guide courts in deciding remedies in the quite different

context presented by claims of the kind litigated in *Davis v. Michigan Dep't of Treasury*, 489 U.S. 803 (1989) where this Court found unconstitutional the taxing of retirement benefits of federal employees while exempting state employee retirees. Fashioning appropriate remedies is, however, a case by case analysis given the prospectivity analysis this Court identified in *ATA* and the variety of options open to a state in fashioning a retroactive remedy under the principles of *McKesson*. Consequently, if guidance is needed for *Davis* remedies it should be given in a *Davis* case, not in a *Memphis Bank* case. In fact, a petition for a writ of certiorari in a *Davis* case has been filed in *Bass v. State of South Carolina*, 395 S.E.2d 171 (S.C. 1990), *petition for cert. filed*, No. 90-673 (October 24, 1990).

Even were it otherwise and this were an area of law crying out for clarification by the Court, this case, when candidly presented, provides no occasion for reversal. That petitioners were not awarded tax refunds constitutes no threat to the immunity of federal obligations, petitioners' doomsday scenario to the contrary. The decision of the Minnesota Supreme Court is consistent with the principles of *McKesson* and *ATA*.

I. DENYING REFUNDS TO THESE PETITIONERS DOES NOT UNDERMINE THE IMMUNITY OF U.S. OBLIGATIONS FROM STATE TAXATION.

Petitioners speculate that if refunds can be denied to taxpayers who have paid a tax that infringes on the immunity of U.S. obligations from state taxation, private tax challenges are an endangered species and the immunity of U.S. obligations itself is imperilled. Pet. 10-12. This

argument mistakenly postulates that without the availability of refunds, no actions will be brought to vindicate the principle of federal tax immunity. Petitioners ignore avenues of enforcement that are not dependent on the availability of refunds.

First, petitioners wrongly assume that the only vehicle by which a private party can challenge a tax as unlawful under the federal obligation immunity principle is an action for refund of back taxes. On the contrary, current Minnesota law allows taxpayers to challenge taxes in the Minnesota Tax Court without prepaying taxes.[7] Similarly, petitioners could have challenged without prepayment taxes due for the 1979 and 1980 tax years, which they voluntarily and without objection paid. The vast majority of other states currently permit tax challenges without prepayment.[8] Because nearly all states permit tax challenges without prepayment, a private right of action for a refund of back taxes is not necessary for the effective private enforcement of the immunity principle.

Petitioners also overlook that the U.S. government itself is hardly powerless to challenge taxes violating the

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[7] A prepayment requirement that was in effect for the 1982-1988 period was repealed in 1989. 1989 Minn. Laws c. 324 § 29. *See also supra* note 3.

[8] Respondents believe only two states (Massachusetts and Washington) presently have a prepayment requirement. Respondents believe, moreover, that those states will react to the *McKesson* decision by repealing their prepayment provisions.

immunity principle. It often has commenced suits to declare state taxes unconstitutional.[9]

Petitioners are therefore wrong in their assertion that the Minnesota Supreme Court's denial of refunds "eviscerates private enforcement of immunity doctrine rights." Pet. 17. As important as the federal immunity principle is to all of our collective interests, it is hardly threatened by denying petitioners refunds in this case.

II. ESTOPPING PETITIONERS WHO WERE BENEFICIARIES OF STATE BOND EXEMPTIONS FROM ASSERTING THAT THE BANK TAX WAS DISCRIMINATORY DOES NOT VIOLATE DUE PROCESS.

Petitioners also assert that they were denied due process by the Minnesota Supreme Court's application of an estoppel doctrine to preclude them from asserting that the bank tax was discriminatory. Pet. 12-15. Their argument is based on a gross mischaracterization of the basis for the state court's ruling.

Petitioners characterize the Minnesota court's decision as imposing a "poll tax"[10] on their ability to

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[9] *See, e.g., United States v. County of Fresno*, 429 U.S. 452 (1977) (government challenged tax on government-owned housing used by private citizen); *United States v. New Mexico*, 455 U.S. 720 (1982) (government challenged a sales/use tax on goods and services purchased by private contractors under contracts with U.S. to manage government-owned laboratories).

[10] A "poll tax" is a "capitation tax" or "tax levied upon each person within the jurisdiction of the taxing power and

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challenge the bank tax in court, which somehow discriminates against holders of federal obligations. This proposition is based on the unsupported premise that the court estopped petitioners' recovery of refunds because they failed to pay a judicially-imposed tax. Nothing in the Minnesota Supreme Court's opinion suggests that rationale. Instead, the court explicitly held that it was petitioners' enjoyment of the benefit of the challenged exemption that precluded their recovery. Pet. App. 8A.

Minnesota has long recognized an acceptance of benefits doctrine in tax cases, under which a taxpayer is estopped from assuming the validity of a statute for the purpose of receiving its benefits and also attacking it as unconstitutional in an attempt to achieve even greater benefits. *See Gale v. Commissioner of Taxation*, 228 Minn. 345, 37 N.W.2d 711 (1949) (taxpayer who claims a tax reduction as a result of a statutory amendment estopped from challenging the effective date of the amendment). The same doctrine is present in federal cases, as acknowledged by petitioners in their reference to *Kadrmas v. Dickinson Pub. Schools*, 487 U.S. 450, 457 (1988), cited at Pet. 13. *See also Magee v. United States*, 282 U.S. 432 (1931) (taxpayer who benefited from a claim in abatement not in a position to challenge its legality); *Strickland v. Flue-Cured Tobacco Coop. Stabilization Corp.*, 643 F. Supp. 310 (D.S.C. 1986) (rebate beneficiaries of federal tobacco price

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within a certain class (as, all males of a certain age, etc.) without reference to his property or lack of it." Black's Law Dictionary 1043 (5th ed. 1979). A poll tax is not much like the reasoning or the result of the Minnesota court's opinion therefore.

support program barred under doctrine of constitutional estoppel from attacking the statute authorizing rebates).

A very similar doctrine is also often applied in federal tax cases and is known as the "duty of consistency" or "quasi-estoppel" doctrine. Under this doctrine a taxpayer who has received a tax benefit due to treatment of an item in a year barred by the statute of limitations as to an additional assessment is precluded from claiming that the original treatment was incorrect in order to obtain a tax advantage in a later year. *See Unvert v. Commissioner,* 72 T.C. 807 (1979); *Griffith v. Commissioner,* T.C.M. (P-H) ¶ 89,070 at 293 (1989); *Coldiron v. Commissioner,* T.C.M. (P-H) ¶ 87,569 (1987).

Thus the applicability of estoppel doctrines is not a revolutionary idea at either the state or federal level. Moreover, the application of these estoppel principles in appropriate cases was not undermined by this Court's recent decision in *McKesson.* In *McKesson* the Court rejected two "equitable considerations" offered by the state. *McKesson,* 110 S.Ct. at 2254.[11] Neither the acceptance of benefits doctrine nor any similar estoppel doctrine was, however, at issue. Nothing in the *McKesson* case should be seen therefore as overruling such traditional equitable doctrines in tax cases.

The justice in applying an estoppel to these petitioners' claims of discrimination is plain. Petitioners are

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[11] The first was that the State had relied in good faith upon a presumptively valid statute. *McKesson,* 110 S.Ct. at 2255-56. The second was of the nature of a pass on defense, that petitioners would receive a windfall from refunds because they likely passed on the tax to consumers. *Id.*

the type of taxpayer who should be estopped from asserting that a tax is discriminatory. They, for example, benefitted from the state tax exemption of IDB's. All four of the test banks (petitioners) were holders of IDB's. All four reduced their Minnesota bank taxes by claiming the IDB interest as exempt income.[12] They so stipulated. Resp. App. 1a.

Yet, to challenge the Minnesota tax as discriminatory they must assert the exemption was unlawful. They must so assert because Minnesota's bank excise tax is a franchise tax which can lawfully include U.S. obligation income in its measure consistent with 31 U.S.C. § 3124(a). Including U.S. obligation interest in the Minnesota tax did not therefore make Minnesota's tax unlawful. It was the enactment of state bond exemptions that it made it so. This is why the Minnesota court held that:

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[12] Petitioners attempt to direct attention away from this undisputed benefit when they contend the interest they received was lower because of the exemption and that the real beneficiaries of the exemption were the issuers. Pet. 14. This is not an argument raised in either the trial court or the Minnesota Supreme Court and is in any event without merit. Petitioners refer to a general finding by the trial court that the exemption caused interest rates to be lower than they would have been otherwise. Pet. App. 24A. This finding does not quantify the amount by which the state bond exemption might lower the rate or whether it is lowered by such an amount to negate the clear tax benefit derived from the exemption. The record is thus insufficient to support what petitioners contend, which in any event is contrary to common sense since they did indeed invest in IDB's presumably for a tax advantage and not out of a sense of public service because issuers were benefited.

> It is the exemption for interest earned on state obligations that makes the bank tax discriminatory and, therefore, unconstitutional.

Pet. App. 9A. Therefore, petitioners' challenge to the bank tax as discriminatory must properly be viewed as an attack on the exemption for income from state obligations from which they benefited. Accordingly, the argument raised by petitioners, Pet. 13, that the acceptance of benefits doctrine does not somehow apply to them because they challenged not the state exemption but the inclusion of federal obligation income is transparent and was rightly rejected by the Minnesota court.

The Minnesota opinion does not establish some new principle fatal to refund actions concerning unconstitutional taxes in general. It merely applies conventional equity doctrines to these petitioners. While other banks who did not own exempt state obligations may challenge the tax as discriminatory these petitioners may not. The decision below merely restricts litigants like petitioners who want to have their cake and eat it too.

III. THE MINNESOTA SUPREME COURT DID NOT ACT INCONSISTENT WITH *MCKESSON* BY NOT, AS A MATTER OF EQUITY, ACTUALLY IMPOSING RETROACTIVE TAXATION WHERE THE PETITIONERS THEMSELVES WOULD HAVE BORNE THE BRUNT OF IT AND WHERE AN ACTUAL TAX WOULD NOT HAVE FURTHERED THE PRINCIPLES OF FEDERAL OBLIGATION TAX IMMUNITY.

Petitioners attack the opinion of the Minnesota Supreme Court contending that the court, contrary to the principles of *McKesson*, imposed only a fictitious tax as

relief – one which was not to be actually collected. Pet. 15-18. The decision below does not, however, conflict with *McKesson*.

The *McKesson* due process right to retroactive relief does not apply to this case because Minnesota differs from Florida in its requirements for prepaying taxes prior to challenging them. In any event, even if a retroactive tax was imposed, it would accomplish nothing beneficial to the principle of federal obligation tax immunity and petitioners themselves would bear the brunt of any retroactive tax. The instant case is therefore much different than *McKesson* where the retroactive relief would have actually equalized an inequality between competitors thereby advancing Commerce Clause objectives.

A. *McKesson* Is Not Applicable Because Minnesota Provided Predeprivation Relief.

In *McKesson* the Court explained:

> *[I]f a State places a taxpayer under duress promptly to pay a tax when due and relegates him to a post-payment refund action in which he can challenge the tax's legality,* the Due Process Clause of the Fourteenth Amendment obligates the State to provide meaningful backward-looking relief to rectify any unconstitutional deprivation.

McKesson, 110 S.Ct. at 2247 (emphasis added) (footnote omitted). Relief may be either through additional tax assessments against the beneficiaries of the discriminatory tax or through an award of tax refunds to the unfavored taxpayers, or from some combination of the two.

Minnesota law, unlike that of Florida in *McKesson*, for two (1979 and 1980) of the five years as to which *Memphis Bank* claims were filed (1979-1983) allowed an appeal to its Tax Court *without* prepayment. No prepayment requirement was enacted until the 1981 tax year. *See* Minn. Stat. § 290.531 (1982). The 1979 year, which was the "test year" selected by stipulation for litigation of this case,[13] was not a year as to which prepayment was required.

Even as to the 1981-1983 tax years for which a prepayment provision was part of Minnesota law (it has since been repealed), the provision had an escape clause. A taxpayer could avoid prepayment on a showing that the appeal was in good faith, that there was probable cause that the taxpayer would be found exempt from the tax or that the tax ultimately determined might be less than fifty percent of that assessed and that prepayment would work a substantial hardship. Minn. Stat. § 290.531 (1982). *See* Resp. App. 6a.

Minnesota thus did provide for meaningful predeprivation relief and the threshold requirements for retroactive relief of any sort cannot be established by petitioners under *McKesson*.

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[13] *See* Pet. 4 n.1.

B. Even Were *McKesson* Applicable, *McKesson* Should Not Be Read To Prohibit A State From Declining, As A Matter Of Equity, To Impose A Retroactive Tax Where The Taxpayers Challenging The Tax Would Themselves Have Borne The Brunt Of It And Where An Actual Tax Would Not Have Furthered The Principles Of Federal Obligation Tax Immunity.

Petitioners criticize the Minnesota Supreme Court for declaring the state bond exemptions unlawful but then not actually imposing a retroactive tax. Pet. 15-18. Petitioners accuse the Minnesota Supreme Court of imposing a "fictitious retroactive tax." They point out that this Court in *McKesson* rejected an argument advanced by the State of Florida that it need not actually impose a retroactive tax and equalize the tax burden between McKesson and its tax preferred-competitors. Florida instead asserted that McKesson should be placed in the same position it would have been in had such a tax been imposed, which, because Florida would have imposed a higher tax on all rather than extending the preferred treatment to all had it known of the illegality of its preference, would be the higher tax. This Court rejected that hypothetical tax argument because it did not place competitors in the same position they would have been absent a Commerce Clause violation. In that context, and in response to that argument, the Court rejected the argument that back taxes need not actually be collected from the preferred competitors.

The effect of the Minnesota Supreme Court's decision is not to impose a "fictitious tax" in the sense rejected in *McKesson*. Under the remedial options approved in *McKesson* the Minnesota Supreme Court could have

elected to impose retroactive taxes on theretofore tax-exempt state bonds. It chose not to do so out of fairness to these petitioners saying, consistent with its opinion that the *Memphis Bank* opinion established a new principle of law, that "ordering actual collection of the tax in this case would unfairly penalize both parties for failing to see the change in the law brought about in *Memphis Bank*." Pet. App. 11A-12A. In such circumstances, where an actual retroactive tax would have fallen on the very taxpayers asserting the discrimination, banks being heavy owners of state bonds,[14] the court thought it inequitable to impose a retroactive tax.

It was within the court's power to impose a retroactive tax consistent with due process had it opted to do so.[15] To do so, however, makes no sense in this case even

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[14] In 1979, for example, financial institutions owned over 61% of outstanding state and local debt held. Flow of Funds Accounts, Financial Assets and Liabilities, Year-End 1966-1989, Federal Reserve System (Sept. 1990) 44 ("Tax-Exempt Securities and Loans (1)", lines 7-19). Corporate holders are the only holders relevant to the instant lawsuit since state obligations held by individuals are tax exempt in Minnesota.

[15] This Court said in *McKesson* that retroactive assessment of a tax increase does not necessarily deny due process to those whose taxes are increased, though beyond some temporal point the retroactive imposition of a significant tax burden may be "so harsh and oppressive as to transgress the constitutional limitation," depending on "the nature of the tax and the circumstances in which it is laid." 110 S.Ct. at 2252 n. 23 (citations omitted). Surely Minnesota could impose back taxes to tax year 1979. Retroactive taxes have in the past been allowed to reach back into distant tax periods. In *Canisius College v. United States*, 799 F.2d 18, 23-27 (2d Cir. 1986), *cert. denied*, 481 U.S. 1014 (1987), the court allowed a four year retroactive

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though it may in a Commerce Clause case like *McKesson*. The Minnesota court properly distinguished *McKesson* on

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period because the retroactive statute ratified earlier conduct and did not unsettle the expectations of the taxpayer. In *Wilgard Realty Co. v. Commissioner*, 127 F.2d 514, 517 (2d Cir.), *cert. denied*, 317 U.S. 655 (1942) seven year retroactive taxation was approved where the taxpayer would not have acted differently.

Petitioners would have acted no differently in investing in state obligations even if they had been taxable. Petitioners likely based their investment decisions upon the federal tax benefits of investing in state and local obligations which included a *double* tax benefit: 1) an exemption under I.R.C. § 103 from the federal corporate income tax of 20%-22% plus a 26% surtax in 1979 and 2) the even more attractive provisions of I.R.C. § 265 as generously interpreted in favor of banks by the I.R.S. in Rev. Proc. 70-20 to allow deductions for interest expense of producing the exempt income. By comparison, an exemption from Minnesota's franchise tax (12% in 1979) is inconsequential. Petitioners would have invested in the exempt state bonds anyway, so their expectations are not unduly interfered with by retroactive taxation.

Imposition of such a tax would not, moreover, be contrary to the Minnesota statute of limitations in tax cases. Petitioners assert that the statute of limitations (normally three and one-half years) has long since expired on 1979. Pet. 17-18 n.11. They are wrong. The basis for assessing tax on the exempted state bonds did not exist until the Minnesota Supreme Court opinion in the instant case declaring those exemptions to be unlawful. Under Minnesota law the statute of limitations would be equitably tolled until the Minnesota court's 1990 opinion. *See Bartlett v. Miller & Schroeder Muns., Inc.*, 355 N.W.2d 435, 439 (Minn. Ct. App. 1984) (citing *Burnett v. New York Cent. R.R.*, 380 U.S. 424, 428 (1965)). *Cf. Bowmen v. City of New York*, 476 U.S. 467, 479 (1986); *Zipes v. Trans World Airlines, Inc.*, 455 U.S. 385,

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the basis of its Commerce Clause underpinnings. In *McKesson* actually assessing back taxes equalized competitors and remedied the Commerce Clause discrimination in a way meaningful for the preservation of Commerce Clause principles. Actually assessing retroactive taxes in the instant case does not, however, further the principles underlying U.S. obligation immunity. Imposing retroactive taxation does not benefit the United States. As petitioners say, any "detriment to the Federal Government", Pet. 17, is a matter of "historical record and cannot now be undone." *Id.*[16] Nor does actually assessing taxes retroactively benefit petitioners. Taxing petitioners to remedy a defect in Minnesota law which they did not foresee (they filed no refund action challenging these years old exemptions until after *Memphis Bank*) seems pointless.

What was necessary to achieve Commerce Clause objectives in *McKesson* is simply not in order here. Thus, the Minnesota Supreme Court acted properly when it

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398 (1982); *Burnett v. New York Cent. R.R.*, 380 U.S. 424 (1965); *Braun v. Sauerwein*, 77 U.S. (10 Wall.) 218, 223 (1869) (cited in the *ATA* dissent, 110 S.Ct. at 2354 (Stevens, J., dissenting) for the proposition that federal courts historically have asserted equitable discretion to craft rules of tolling, laches, and waiver).

[16] The trial court made no finding as to any actual damage to the Federal Government resulting from the Minnesota exemption. The $1.75 billion figure mentioned at Pet. 5 is hypothetical and is premised on the assumption that all 50 states had a tax system like Minnesota's. The Minnesota Supreme Court said it could not conclude that this hypothetical finding by the trial court was "clearly erroneous." Pet. App. 8A.

distinguished *McKesson* as a case where an actual retroactive tax was necessary to cure economic disadvantages caused by the discriminatory tax. Pet. App. 11A.

McKesson recognized that states ought to have options and flexibility in fashioning a remedy. The Minnesota court has surely exercised its discretion in those respects in a responsible fashion in the instant case.

IV. THE MINNESOTA SUPREME COURT'S HOLDING THAT *MEMPHIS BANK* SHOULD BE APPLIED PROSPECTIVELY ONLY IS CONSISTENT WITH OPINIONS OF THIS COURT AND IS CONSISTENT WITH THE OPINION OF THE ONLY OTHER STATE COURT TO RULE ON THE ISSUE.

Petitioners assert that the third prong of the Minnesota Supreme Court's decision denying petitioners refunds – that the *Memphis Bank* opinion should be applied prospectively only – is in conflict with decisions of this Court. Pet. 18-22. It is not.

The Minnesota court applied the three part analysis[17] of *Chevron Oil Co. v. Huson*, 404 U.S. 97 (1971) and

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[17] *First*, the decision to be applied nonretroactively must establish a *new principle of law*, either by overruling clear past precedent on which litigants may have relied, *or* by deciding an issue of *first impression* whose resolution was *not clearly foreshadowed*. *Second*, it has been stressed that "we must- . . . weigh the merits and demerits in each case by looking to the prior *history* of the rule in question, its *purpose* and *effect*, and whether retrospective operation will further or retard its operation." *Finally*, we

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determined *Memphis Bank* should be prospective only. The Supreme Court of Oklahoma earlier found the same in *First of McAlester Corp. v. Oklahoma Tax Comm'n*, 709 P.2d 1026 (Okla. 1985). The Oklahoma and Minnesota courts are the only courts to have ruled on the issue.[18] It simply involves application of the well-known *Chevron* test to particular circumstances of this case. There is no split among the courts on the issue. There is thus no need to review the prospectivity issue.

A. The *Memphis Bank* Opinion Decided An Issue Of First Impression Whose Resolution Was Not Clearly Foreshadowed.

In *ATA* this Court found that the decision in *American Trucking Ass'ns, Inc. v. Scheiner*, 483 U.S. 266 (1987), which expressly overruled earlier cases, should be applied prospectively. In the *McKesson* case no issue of prospectivity was considered by the Court since the case pertained to

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> have weighed the *inequity* imposed by retroactive application, for "[w]here a decision of this Court could produce substantial inequitable results if applied retroactively, there is ample basis in our cases for avoiding the 'injustice or hardship' by a holding of nonretroactivity."

Chevron Oil Co. v. Huson, 404 U.S. at 106-07 (citations omitted) (emphasis added).

[18] No prospectivity issue was present in the *Memphis Bank* case itself because the State of Tennessee had (unwisely) stipulated that if federal interest was excluded no tax was due. *See Memphis Bank*, 459 U.S. at 396.

Apparently, no other state courts have considered the issue. Respondents are aware of no other pending cases on the issue.

taxes paid after the Court's opinion in *Bacchus Imports, Ltd. v. Dias*, 468 U.S. 263 (1984) and the law was thus clear without question. In *Ashland Oil, Inc. v. Caryl*, 110 S.Ct. 3202 (1990), this Court held that while *Armco Inc. v. Hardesty*, 467 U.S. 638 (1984), contributed to the development of the Court's Dormant Commerce Clause jurisprudence it was clearly foreshadowed by earlier decisions.[19]

Respondents candidly observe that this case is between the extremes presented by *ATA* (express overrule) and *McKesson* (a state tax which virtually was enacted in blatant disregard of a recent precedent). Like *Ashland* it is somewhere in the middle of the continuum. Unlike *Ashland*, however, there was no clear trend of recent decisions of this Court which clearly foreshadowed *Memphis Bank*.

Memphis Bank came as a surprise to both states and taxpayers. While petitioners argue that the Minnesota court's prospectivity holding is a "pretext designed to cover the court's blatant disregard for federal constitutional rights," Pet. 21, they seem to forget to ask themselves why, if the particular federal right at issue in this case was clearly established prior to the 1983 *Memphis Bank* opinion, did not one of Minnesota's approximately 700 banks – the most sophisticated of taxpayers – challenge Minnesota's tax until after *Memphis Bank*. Surely petitioners cannot claim they were ignorant of the exemptions – they directly benefited from the IDB exemption.

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[19] The Court in *Ashland* referred to its 1981 opinion in *Maryland v. Louisiana*, 451 U.S. 725 (1981) and its 1977 opinion in *Boston Stock Exch. v. State Tax Comm'n*, 429 U.S. 318 (1977) as foreshadowing the *Armco* decision.

Petitioners make much of language in the Court's *Memphis Bank* opinion that the Court had "frequently considered" the discrimination issue and that its decision was "clear" under principles of earlier cases. Pet. 20. The petitioners fail to observe, however, that this Court also noted that the *Memphis Bank* case presented the first occasion to determine whether a tax was discriminatory since the 1959 enactment of 31 U.S.C. § 3124 (then § 742). *Memphis Bank*, 459 U.S. at 396. And with all due respect to the Court's statement that the nondiscrimination rule had been frequently considered, none of the decisions which the Court identified as framing the constitutional rule which the statute embodies involve fact situations very similar to that presented in *Memphis Bank*. And, it must be recalled, tax law is a highly conceptual area of the law where seemingly minor differences in form or structure portend major differences in result.

The states found themselves in an embarrassing position after the *Memphis Bank* opinion because they had had state bond exemptions in their tax systems for years. Respondents believe that the states enacted their franchise tax systems exempting state/local bonds but taxing federal bonds in reliance on language in the opinion in *Miller v. City of Milwaukee*, 272 U.S. 713 (1927). Language in *Miller* suggested that unless a state tax policy amounted to an intentional interference with or evasion of federal obligation immunity principles it was not unlawful. In *Miller* the Court held unlawful a Wisconsin corporate income tax (not a franchise tax) provision which taxed shareholders on dividends received which applied only when the corporation paying the dividend earned exempt (U.S. obligation) income. The Court found

this to be an "intentional interference" with and an evasion of U.S. obligation immunity principles.

In the *Miller* opinion, however, the Court said:

> *If the avowed purpose or self-evident operation of a statute is to follow the bonds of the United States* and to make up for its inability to reach them directly by indirectly achieving the same result, the statute must fail. . . . We think it would be going too far to say that they [(the Acts of Congress)] allow *intentional interference* that is only prevented from being direct by the artificial distinction between a corporation and its members. *A tax very well may be upheld as against any casual effect it may have upon the bonds of the United States when passed with a different intent and not aimed at them, but it becomes a more serious attack on their immunity when they are its obvious aim.*

272 U.S. at 715 (emphasis added). Respondents believe that state practices of exempting local bonds while taxing U.S. obligations under their franchise taxes took root in this statement. Exempting local bonds, at an actual revenue cost to the state, with a motive of furthering the public policy purpose of that type of bond and without any devious motive to improperly tax U.S. bonds, would seem to pass muster under such a standard.

While petitioners suggest that there exists a veritable plethora of precedents of this Court which could be said to portend *Memphis Bank*, they mention only *Schuylkill Trust Co. v. Pennsylvania*, 296 U.S. 113 (1935). Respondents agree that *Schuylkill* is the only decision of the Court which even arguably foreshadowed *Memphis Bank*.

In the 1935 *Schuylkill* opinion, this Court considered not a franchise tax measured by income but rather a

property tax on bank shares. The Court held that excluding from the computation of net taxable assets securities issued by certain Pennsylvania corporations, while including U.S. obligations in the computation, discriminated against the Federal Government. The analysis in *Schuylkill* is murky because in large part it dealt with the question of whether the incidence of the tax was on stock shares, as such, or on the banks assets which included government securities. 296 U.S. at 119. The opinion therefore did not establish any clear general rule and could well have been thought to be of narrow application and confined to the peculiarities of the tax at issue. The majority opinion said nothing inconsistent with the language in *Miller* and the dissent mentioned the *Miller* unfriendly discrimination standard discussed above, *id.* at 127 (Cardozo, J., dissenting).

Respondents do not quarrel with the Court's decision in *Memphis Bank*, but ask the Court to recognize that this is an area of little precedent and one in which states assumed a legal standard (that of *Miller*) for many years. The tax practices they established were not challenged for many years. Respondents submit that in such circumstances it cannot be said that *Memphis Bank* was clearly foreshadowed.

Petitioners make much of the 1939 opinion of the Minnesota Supreme Court in *State v. Duluth, M. & N. Ry.*, 207 Minn. 618, 292 N.W. 401 (1939), *reh'g. denied*, 207 Minn. 637, 292 N.W. 411 (1940), *cert. denied*, 311 U.S. 719 (1941). This opinion, as petitioners observe, was not addressed by the Minnesota Supreme Court in its decision in the instant case. Petitioners do not similarly observe that the trial court which decided every issue in

petitioners' favor, did not mention it in its order on Phase I (liability) of the case and thus did not regard it as relevant either.[20]

The actual holding of the Minnesota Supreme Court in *Duluth Ry.* was based on its construction of a statute, not the Constitution. 1933 Minn. Laws, c. 405, § 12(g) provided for the following statutory exemption from gross income:

> (g) Income received from the United States, its possessions, its agencies, or its instrumentalities, so far as immune from state taxation under federal law.

The court said of this statutory exemption:

> *Subsection (g)* by expressly exempting income from federal securities so far as immune from state taxation under federal law, in effect, *provides that such income shall not be included in the measure of the franchise tax. Although a state may constitutionally impose a franchise tax measured by income,* including income from tax-exempt securities, . . . *subsection (g) provides that such income shall not be included as a measure of the tax on the franchise.*

207 Minn. at 626, 292 N.W. at 406 (citations omitted) (emphasis added). The court thus interpreted subsection (g) as an indication of the legislature's intent that no federal interest should be included in the measure of the

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[20] The opinion was referred to only as an afterthought in the trial court's Phase II order (remedy). Pet. App. 40A-41A.

corporate tax. This determination of legislative intent did not foreshadow a ruling on federal constitutional law.[21]

Surely the Minnesota and Oklahoma Supreme Courts were correct in applying the *Chevron* analysis and concluding that *Memphis Bank* was not clearly foreshadowed.

B. Retroactive Application Will Not Advance The Operation Of The Principle Of Federal Obligation Tax Immunity.

The second *Chevron* criterion[22] also weighs in favor of the Minnesota Supreme Court's decision. The objective of the federal tax immunity principle is to protect the investment attractiveness of U.S. obligations. This objective will not be advanced by retroactive application of the *Memphis*

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[21] Even such dicta as appears in the opinion subsequent to the court's rendering of its holding on statutory grounds does not clearly foreshadow a holding of the United States Supreme Court to be rendered 44 years later. No dicta in such an obscure case should be regarded as foreshadowing anything. The case was indexed by West Publishing under a railroad taxation key number. Likely as a consequence, it has not been cited on the United States obligation interest issue in any subsequent opinion. Despite numerous refund claims having been filed with the Commissioner on the basis of *Memphis Bank*, no one even discovered the *Duluth Ry.* case until early November 1986 when the instant case was on the eve of trial. Petitioners will observe that it was contained in an annotation in Minnesota Statutes Annotated. This apparently did not, however, assist anyone in finding it. By reason of its very obscurity, the dicta in *Duluth Ry.* cannot be said to clearly foreshadow *Memphis Bank.*

[22] *See supra* note 17.

Bank opinion. Retrospective application and refunds for petitioners would not further the purpose of the tax immunity rule because investment decisions were made before the decision. Paying banks refunds today will not retroactively make federal obligations more attractive.

Nor is it necessary to punish states as a deterrence measure. Just as Oklahoma did, Minnesota promptly responded by removing any discriminatory aspect of its tax[23] shortly after the *Memphis Bank* decision and before any refund claims challenging the tax were filed. No threat of punishment was necessary to induce Minnesota to correct its system. Should some state not act in good faith in the future, that can be given consideration by the Court as an equity against the state, as it clearly was in *McKesson*.

Punishment is not appropriate for its own sake nor is it necessary to give taxpayers incentives to challenge unlawful tax systems. *See supra* Argument section I.

The goal of the federal policy not being furthered by retrospective application, this second factor of the *Chevron* prospectivity analysis strongly leans in favor of prospective application.

C. Retroactive Application Of *Memphis Bank* Would Produce A Substantially Inequitable Result.

The equities[24] surely weigh heavily against petitioners. These include the following: 1) petitioners

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[23] *See* 1983 Minn. Laws c. 213.

[24] *See supra* note 17.

themselves benefited from state bond exemptions which made the tax discriminatory, 2) because petitioners are heavy holders of U.S. obligations, refunds would minimize or eliminate their tax liability allowing them to freeload on other taxpayers for the cost of government, and 3) refunds confer a windfall on petitioners since they never had any expectation other than that U.S. obligations would be included in the Minnesota tax.

D. The Dissenters In *ATA* Should Agree With The Decision Of The Minnesota Supreme Court.

There is plainly a philosophical difference of opinion on the Court as to whether civil cases should be applied prospectively only. However that issue ultimately resolves itself, it should not alter the outcome in this case.

Even if retroactivity principles are regarded as "remedial principle[s] for the exercise of equitable discretion by federal courts," *ATA*, 110 S.Ct. at 2353 (Stevens, J., dissenting), as opposed to choice of law principles, equitable principles surely weigh in favor of the result reached by the Minnesota Supreme Court.

The fundamental equity in respondents' favor in this case is premised upon an examination of whose expectations were violated by the *Memphis Bank* opinion. The decision was a surprise to all involved – to both the states, who had for years included federal interest in their franchise taxes while exempting state obligations, and to taxpayers such as petitioners, who paid the tax for years without objection and filed refund claims only after the 1983 *Memphis Bank* decision. The states expected that their taxes were lawful and relied on that expectation in

collecting and spending revenue. The petitioners did not prior to 1983 have any expectation that federal obligation interest would not be taxed. They did not, for example, buy federal obligations on the assumption that they would not be taxed only to have that assumption later violated. Clearly, all of the reliance interests in the analysis favor respondents.

However the philosophical division on the Court on the prospectivity/retroactivity issue be resolved, this case should still be decided in respondents' favor.

CONCLUSION

For the foregoing reasons the petition should be denied.

Respectfully submitted,

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Phase I Stipulation of Facts ¶7:

In all tax years in issue, Norwest Bank Duluth, Cambridge State Bank, Midway Bank St. Paul, and First Security State Bank Sleepy Eye have received interest income on industrial development bonds ("IDB's") pursuant to Chapter 474 of Minnesota Statutes and pursuant to Minn. Stat. § 474.12, subd. 1 (repealed 1983, Minn. Laws, c. 213) did not include in the measure of their taxable net income under Minn. Stat. § 290.361 any interest received on IDBs issued prior to July 1, 1979.

Phase I Stipulation of Facts, Ex. M-9:

FAEGRE & BENSON

1300 NORTHWESTERN BANK BUILDING

MINNEAPOLIS, MINNESOTA 55402

612/371-5300

$2,360,000 Minnesota Higher Education Facilities Authority Mortgage Revenue Bonds, Series W (Bethel College)

We hereby certify that we have examined certified copies of proceedings taken preliminary to and in the issuance by the Minnesota Higher Education Facilities Authority (the "Authority"), of its negotiable coupon, registrable First Mortgage Revenue Bonds, Series W (Bethel College) in the aggregate principal amount of $2,360,000, dated August 1, 1978, consisting of 472 bonds numbered 1 to 472 in the denomination of $5,000 each, maturing on April 1 in years and amounts as follows:

$ 10,000 in 1979,
$ 50,000 in 1980 to 1985,
$ 75,000 in 1986 to 1990,
$100,000 in 1991 to 1994,
$125,000 in 1995 to 1997,
$150,000 in 1998 to 2000, and
$450,000 in 2001, all years inclusive,

All bonds maturing on or after April 1, 1995 being subject to redemption in inverse numerical order at the option of the Authority on April 1, 1994 and any interest payment date thereafter at par plus accrued interest, all bonds also being subject to redemption at par plus accrued interest in whole in certain events of damage to or condemnation of the Project and change of law or circumstances and in certain cases of interest on the bonds becoming subject to

federal income taxation as provided in the Indenture and Lease, and bearing interest at the rates per annum according to years of maturity as follows:

1979	to 1991	maturities at 7.00%,
1992		maturities at 6.90%,
1993		maturities at 6.40%,
1994		maturities at 6.50%,
1995		maturities at 6.60%,
1996		maturities at 6.70%,
1997		maturities at 6.75%,
1998		maturities at 6.80%,
1999		maturities at 6.90%, and
2000	to 2001	maturities at 7.00%, all years inclusive,

interest payable April 1, 1979 and semiannually thereafter on October 1 and April 1 in each year, both principal and interest payable at the Northwestern National Bank of Minneapolis, in Minneapolis, Minnesota (the "Trustee"), issued for the purpose of financing the cost of constructing two housing residences with appurtenant furnishings and equipment and site improvements (the "Project") at Bethel College (the "College"), in Arden Hills, Minnesota; and have also examined executed copies of the Agreement dated as of May 23, 1978, between the Authority and the Baptist General Conference (the "Conference"), an Illinois non-profit corporation, as owner and operator of the College (the "Agreement"), the deed of the Project site from the Conference to the Authority (the "Deed"), the Lease dated as of July 1, 1978 between the Authority and the Conference (the "Lease"), the Mortgage Trust

Indenture dated as of July 1, 1978 between the Authority and the Trustee (the "Indenture"), and the Guaranty Agreement dated as of July 1, 1978 between the Conference and the Trustee (the "Guaranty") referred to in the Bonds, together with a mortgagee's title policy issued by Chicago Title Insurance Company, one of the executed Bonds (No. 1) and such other documents as we deemed necessary for the purpose of the following opinion.

From such examination, it is our opinion that:

1. The Authority is an agency of the State of Minnesota with authority under Sections 136A.25 to 136A.42, Minnesota Statutes, to issue the Bonds, to acquire and lease to the Conference, acting for and on behalf of the College, the Project and to execute and deliver the Indenture to secure the Bonds.

2. The Bonds, the Deed, the Agreement, the Lease, the Indenture and the Guaranty have been duly authorized by all necessary proceedings and duly executed and delivered.

3. The Bonds, the Lease, the Indenture and the Guaranty are valid and binding instruments enforceable in accordance with their terms, subject to bankruptcy and similar laws affecting the enforcement of creditors' rights generally.

4. The Indenture provides a valid and direct first mortgage lien on the Project and the site thereof subject only to the Lease and encumbrances permitted by the Indenture.

5. The Bonds are further secured by the General Bond Reserve Account established by the Authority by its

General Bond Resolution dated October 31, 1972, on a parity with bonds of other series as provided in the General Bond Resolution.

6. The interest on the Bonds is exempt from federal and Minnesota state income taxation (other than Minnesota corporate franchise taxes measured by income) under present laws and rulings.

7. The Bonds are exempt from registration under the Securities Act of 1933 and Minnesota Statutes, Chapter 80A, and the Indenture is exempt from qualification under the Trust Indenture Act of 1939.

Dated at Minneapolis, Minnesota, August 7, 1978.

Minn. Stat. § 290.531 (1982):

When a taxpayer appeals his tax liability under this chapter to the tax court, and the amount in dispute is more than $4,000, the entire amount of the tax shall be paid at the time it is due unless permission to continue prosecution of the petition without payment is obtained as provided herein. The petitioner, upon ten days notice to the commissioner, may apply to the court for permission to continue prosecution of the petition without payment; and, if it is made to appear

(1) That the proposed review is to be taken in good faith;

(2) That there is probable cause to believe that the taxpayer may be held exempt from the tax or that the tax may be determined to be less than 50 percent of the amount due; and

(3) That it would work a substantial hardship upon petitioner to pay the tax, the court may permit the petitioner to continue prosecution of the petition without payment, or may fix a lesser amount to be paid as a condition of continuing the prosecution of the petition.

Failure to make payment of the amount required when due shall operate automatically to dismiss the petition and all proceedings thereunder unless the payment is waived by an order of the court permitting the petitioner to continue prosecution of the petition without payment.